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INSIGHT

MONTHLY COMMENTARY

December Agency MBS Update

STEPHEN K. LEECH | JANUARY 5, 2017

December largely reflected the trends seen over the full year across the agency MBS universe. Sparse news contributed to continued and pervasively low volatility, driving positive excess returns in the final month of 2017. December marked the fourth consecutive month of positive relative performance, allowing the agency MBS basis to close December on an absolute tear. The positive performance comes at a time when the tailwinds driving the agency MBS basis tighter seemed to be dissipating. The Federal Reserve is now running down its balance sheet, slowly removing some of the non-economic buying that has benefitted the relative and absolute valuations of agency MBS. Furthermore, there has been a persistent expectation that volatility would pick up in financial markets, either due to the Fed or due to some unforeseen event, and would negatively impact agency MBS valuations. Instead, the yield curve flattened on expectations of the Federal Reserve continuing to hike interest rates. Short-term interest rates edged higher in the month as interest rates on longer duration issues stagnated under the weight of a subdued inflation outlook. Stable longer-term interest rates remained highly beneficial to the agency MBS basis this year, helping to push prepayment concerns to the sidelines. The net result is both a month and a year that was conducive to relative outperformance of agency MBS securities. Nine of the twelve months in 2017 produced positive excess performance for agency MBS, as investors benefited from relatively smooth sailing. At month end, the Bloomberg Barclays MBS Index posted excess returns of 16 basis points (bps) relative to benchmark U.S. Treasuries , closing the year with 52bps of excess returns.

Coupon stack performance in December was once again heavily impacted by the changing slope of the yield curve. Lower coupons posted positive performance once again, with Fannie Mae 30yr (FNCL) 3s posting positive excess returns of 27bps and FNCL 4s showing positive relative returns of 19bps. Yearly FNCL intra coupon stack performance flowed in the same vein, with lower coupons outperforming. FNCL 3s posted excess returns of 113bps in 2017, outflanking FNCL 4s, which delivered just 59bps of excess returns. The yield curve flattened sharply throughout 2017. The spread between 2yr U.S. Treasuries and 10yr U.S. Treasuries dropped from 120bps

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to 52bps over the course of 2017, with 10bps of the move coming in the final month of the year. Short term interest rates continue to edge up on widespread belief that with unemployment below historic norms the Federal Reserve will continue to raise rates. The challenge is that a strong showing by risk assets over the past year has not pushed longer term interest rates higher. Specifically the 30yr mortgage rate declined from 4.39% at the beginning of the year to 4.19% at the close. While stagnant mortgage rates were beneficial to performance in aggregate, they proved particularly helpful to lower coupon and production MBS. The lack of prepayment volatility provided a powerful tail wind, allowing the market to shrug off the potential risks of flat yield curves. Specifically, a negative sloping yield curve, which is a scenario that is now at least on the radar, has proven to be a particularly prescient indicator of forthcoming market peril. A downturn in risk assets would certainly pose a new challenge for agency MBS investors if such an event occurred. Until then, higher coupons will look for mean reversion or a change in underlying dynamics to carry coupon stack performance back toward higher coupon agency MBS.

There was a paucity of regulatory news in December, but what came to the forefront was problematic for Ginnie Mae collateral. Specifically, the issue of fast prepayments in high coupon Ginnie Mae pools, primarily due to loans originated to veterans and their families, bubbled to the surface once again in December. Prior to this month, Ginnie Mae had set out to find a solution to the perception that servicers were 'churning' loans made to veterans. Servicers were allegedly reaping the benefits of fees related to closing new loans while not actually creating economic value for the veteran borrowers. A task force between the Department of Veterans Affairs and Ginnie Mae was set up to investigate the problem, making investors believe that Ginnie Mae would be aggressive in cleaning up the practices that were leading to such fast prepayments. Early in December Ginnie Mae announced an initial set of new policies to combat the problem, underwhelming even the most timid of prognosticators. The initial policy appears to lack anything that will materially alter the prepayment picture. Specifically, Ginnie Mae announced that the agency would be looking into servicers that are out of step with market peers and would be making speeds a factor in evaluating participating servicers. Furthermore, cash-out and streamline refinance pools would only be deliverable into TBA if the borrowers had made six payments, and 210 days had elapsed on the loan. This change would not go into effect until April of 2018. The result of these changes is very mild. Speeds might be reduced for an extra month before spiking, but with no concrete rules it is unlikely prepayments will materially fall overall. Prior to the announcement, the market had been anticipating something along the lines of a net benefit test that would actually prohibit servicers from making loans that delivered no economic benefit for the borrower. Instead, the only action announced thus far is nebulous at best and nearly useless at worst. Ginnie Maes underperformed notably on the news and the month, as investors now have legitimate reason to worry no help will be the horizon in 2018. As the task force has not concluded its work, further announcements are quite possible.

The story of 2017 was one of historically low volatility, minimal prepayment concern, and strong risk market valuations that pushed agency mortgage valuations into positive territory. While there is a case for each factor to persist into 2018, it has rarely been the case in markets that things stay the same for too long. Just 18 months ago, a seismic prepayment wave was brewing on the back of an unexpected decision by British voters to leave the European Union. One year ago, much of the risk was thought to be the opposite, that strong U.S. growth from the surprising U.S. election result would cause extension risk to be the primary challenge confronting agency MBS investors in 2017. Neither of those fears fully came to fruition, but both are illustrative of the constantly changing landscape of financial markets, and agency MBS in particular. After a year largely devoid of macro shocks, where most of the perilous headlines came from regulatory concerns, it should not be considered a given that 2018 will look the same as the year just passed. Ultimately, after a year of historically low volatility and surging risk assets, discretion may be the better part of valor as the calendar flips to 2018.

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Coupon Stack Performance

30 Yr FNMA	December Month End Price	Monthly Price Change (pts)	Monthly Performance vs. U.S. Treasury (%)	December Month End Libor OAS (bps)	Libor OAS Monthly Change (bps)
3.0	$100.05	0.28	0.27	16.40	-0.60
3.5	$102.73	0.19	0.23	17.00	0.30
4.0	$104.61	0.09	0.19	40.00	-0.90
4.5	$106.42	0.03	0.15	53.30	1.00
5.0	$107.48	-0.66	-0.29	68.70	12.20
5.5	$109.61	-0.44	0.00	77.60	6.30
6.0	$111.86	-0.13	0.06	71.10	3.30
15 Yr FNMA					
2.5	$99.92	0.13	0.23	3.90	-1.90
3.0	$101.89	0.00	0.14	37.90	-0.30
3.5	$103.23	-0.09	0.07	79.50	-7.20
4.0	$102.45	-0.38	0.02	159.00	-0.50
4.5	$101.27	-0.38	-0.03	186.90	-2.70
5.0	$101.67	0.16	0.00	147.20	-2.40
5.5	$99.70	0.00	0.00	89.00	-4.80

Source: TCW, Bloomberg Barclays

Benchmark Performance

	December Month End Price	December Month End Yield (%)	November Month End Yield (%)	Change (bps)
2 Yr Treasury	$99.98	1.88	1.78	10.10
5 yr Treasury	$99.61	2.21	2.14	6.89
10 Yr Treasury	$98.63	2.41	2.41	-0.43
30 Yr Treasury	$100.20	2.74	2.83	-8.70
2/10 Curve		51.84	62.37	-10.52
2 Yr SWAP Spread		18.75	19.01	-0.26
10 Yr SWAP Spread		-0.38	-1.13	0.75
1*10 Swaption Vol		59.99	63.05	-3.05
5*10 Swaption Vol		66.42	71.89	-5.46

Source: TCW, Bloomberg

Issuer Performance (ticks)

	December GN-MAII/FNMA	Monthly Price Change	December GOLD/FNMA	Monthly Price Change
3.0	28.75	-4.75	0.25	0.00
3.5	23.25	-5.50	0.38	0.38
4.0	-10.25	-9.00	0.00	0.63
4.5	-46.50	-13.25	-2.00	0.25
5.0	-25.50	6.25	-2.00	10.00
5.5	-51.88	-1.25	-8.00	4.00

Source: TCW, Credit Suisse

Specified Pool Pay-up Grid (ticks)

Coupon	Dec 29, 2017	Nov 30, 2017	Dec 30, 2016
FN 3% LLB	17	16	11
FN 3% MLB	13	11	9
FN 3% HLB	10	7	7
FN 3% 125 LTV	-8	-8	-8
FN 3.5% LLB	32	31	30
FN 3.5% MLB	27	26	24
FN 3.5% HLB	21	20	18
FN 3.5% 125 LTV	8	8	10
FN 4% LLB	61	60	48
FN 4% MLB	52	52	38
FN 4% HLB	42	42	30
FN 4% 125 LTV	24	24	22
FN 4.5% LLB	97	93	62
FN 4.5% MLB	81	78	48
FN 4.5% HLB	65	62	38
FN 4.5% 125 LTV	44	44	26

Source: TCW, Credit Suisse, Citi

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